

REPORT OF EXAMINATION  
OF THE  
VALLEY INSURANCE COMPANY  
AS OF  
DECEMBER 31, 2009

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Participating State  
and Zone:

California

Filed June 16, 2011

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Los Angeles, California  
May 6, 2011

Honorable Joseph Torti, III  
Chairman of the NAIC Financial  
Condition Subcommittee  
Superintendent of Business Regulation  
Division of Insurance  
Cranston, Rhode Island

Honorable Linda S. Hall  
Secretary, Zone IV-Western  
Director of Insurance  
Alaska Division of Insurance  
Anchorage, Alaska

Honorable Dave Jones  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman, Secretary, and Commissioner:

Pursuant to your instructions, an examination was made of the

VALLEY INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 8360 LBJ Freeway, Suite 400, Dallas, Texas 75243. The Company's statutory home office is located at 818 West 7<sup>th</sup> Street, Los Angeles, California 90017.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2006. This examination covers the period from January 1, 2007 through December 31, 2009. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2009, as deemed

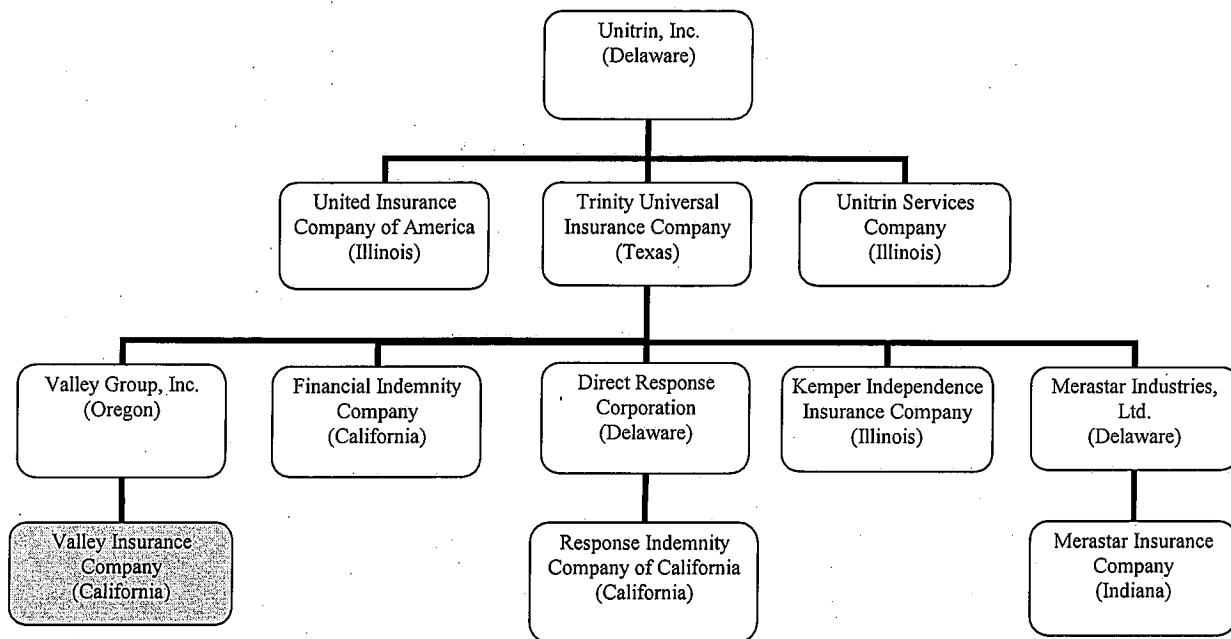
necessary under the circumstances.

The examination was a multi-state coordinated examination and was conducted concurrently with the examinations of its California affiliates: Financial Indemnity Company and Response Indemnity Company of California, and other insurance entities in the holding company group and included participation from the following States: Alabama, Connecticut, Indiana, Illinois, Missouri, Oklahoma, and Wisconsin.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees', and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

#### MANAGEMENT AND CONTROL

The Company is part of an insurance holding company system of which Unitrin, Inc. is the ultimate controlling entity. The following abridged organizational chart depicts the Company's relationship within the holding company system (all ownership is 100%):



Management of the Company is vested in a seven-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2009 follows:

#### Directors

##### Name and Residence

##### Principal Business Affiliation

John M. Boschelli  
Geneva, Illinois

Vice President  
Unitrin, Inc.

Samuel L. Fitzpatrick\*  
Burr Ridge, Illinois

Associate General Counsel  
Unitrin, Inc.

Denise I. Lynch  
Ponte Vedra Beach, Florida

President  
Valley Insurance Company

Christopher L. Moses  
Chicago, Illinois

Vice President and Treasurer  
Unitrin, Inc.

Richard Roeske  
Naperville, Illinois

Vice President and Chief Accounting Officer  
Unitrin, Inc.

Name and ResidencePrincipal Business Affiliation

James A. Schulte  
Jacksonville, Florida

P & C Group Executive  
Unitrin Services Group

Francis J. Sodaro  
Park Ridge, Illinois

Vice President and Assistant Controller  
Unitrin Services Company

\*Replaced by Dennis J. Sandelski, effective December 30, 2010

Principal OfficersNameTitle

Denise I. Lynch  
Clark H. Roberts  
Keith D. Sievers  
Dorothy A. Langley

President  
Vice President and Treasurer  
Senior Vice President  
Vice President and Secretary

Management Agreements

General Service Agreement: The Company entered into a general service agreement, effective July 1, 2004, with Unitrin Services Company (USC). Under the terms of the agreement, USC provides the Company with certain services, such as trade execution and investment analysis, financial accounting and reporting, purchasing and accounts payable, investment accounting, tax return preparation, tax accounting and tax advice, maintenance of benefit plans, administration of post-retirement medical benefits (if applicable), benefit plan regulatory reporting and support, risk management, automobile fleet management, internal audit, cash management and bank relations, financial planning and analysis of results of operations, capital project review and evaluation, real estate management, corporate secretarial functions, and legal support and advice. In return, the Company pays USC for the services provided based on the premiums plus net investment income of the Company as a percentage of total premiums of all affiliates of USC or hourly rate depending on different kinds of service. This agreement was originally approved by California Department of Insurance (CDI) on June 16, 2004; amendment numbers one and two were approved on January 3, 2008 to extend the terms of the agreement and to clarify cost projections, services and record control.

The expenses charged by the Company were \$133,684, \$58,860, and \$87,002 for 2007, 2008, and 2009, respectively.

**General Services Agreement:** The Company entered into a general service agreement with Merastar Insurance Company (Merastar), an affiliate, effective January 1, 2009. Under the terms of this agreement, Merastar shall administer the new and renewal property and casualty lines insurance business of the Company, as well as provide the Company with services such as, marketing, underwriting, claim adjusting, reinsurance reporting, facilities, supplies, staffing, and accounting. Direct expenses shall be charged on an actually incurred basis. Shared or indirect expenses shall be apportioned to the Company based on cost studies and usage metrics of services provided. The Company paid \$2.9 million in 2009. The agreement was approved by the CDI on December 1, 2008.

**Computer Services Agreement:** On July 1, 2004, the Company entered into a computer service agreement with Unitrin Services Company (USC). This agreement was originally approved by the CDI on June 16, 2004; amendment numbers one and two were approved on January 3, 2008. Under the terms of the agreement, USC provides the Company with computer data processing services using computer systems maintained by USC. In addition, USC provides the Company with consulting services, including purchase, implementation, and maintenance of hardware and software. The Company compensates USC an allocated cost portion relating to its usage of USC's computer systems, and the Company fully compensates USC the costs of any computer purchases made on behalf of the Company by USC. This agreement has been extended to June 30, 2013 and approved by CDI on June 30, 2010. The expenses charged by the Company were \$152,812, \$83,933, and \$52,089 for 2007, 2008, and 2009, respectively.

**Information Technology Services Agreement:** The Company entered into an Information Technology Services Agreement with Unitrin Direct Property & Casualty Company (UDPC), an affiliate, effective January 1, 2009. Under the terms of this agreement, UDPC provides information technology services, such as IT applications and consulting services with respect to technology shared among the Unitrin, Inc. property and casualty affiliates. Direct expenses shall be charged on an actually incurred basis. Shared or indirect expenses shall be apportioned to the Company based on cost studies and usage

metrics of services provided. The Company was charged \$33,000 in fees during 2009. The agreement was approved by the CDI on December 1, 2008.

Administrative Services Agreement: Effective April 30, 2009, the Company entered into an administrative services agreement (ASA) with Trinity Universal Insurance Company (Trinity) for the provision of insurance banking facilities and premium collection and disbursement services related to the Amended 90% quota share reinsurance agreement (QSRA), effective April 1, 2005, between the Company and Trinity at the request of the CDI. No separate compensation shall be paid as the parties agree that compensation due Trinity pursuant to the QSRA shall adequately compensate Trinity for the services. The ASA was approved by the CDI on June 1, 2009. Subsequently this ASA was amended and restated, effective January 1, 2010, to continue to provide the services to the Second Amended and Restated 100% QSRA, effective July 1, 2009. This ASA amendment was approved by the CDI on December 10, 2010.

Federal Income Tax Agreement: Under the terms of a consolidated federal income tax agreement, effective December 31, 1999 and approved by the CDI on December 3, 1999, the Company, its ultimate parent, Unitirin, Inc., and affiliates file a consolidated federal income tax return. Pursuant to the agreement, the Company's tax liability is the same as it would have been had it filed on a separate, stand-alone basis, and during the examination period, no federal income taxes were paid by the Company. The tax agreement has been amended various times to add and delete other entities. Each of these amendments were made after January 1, 1997, and are subject to the prior approval requirements of California Insurance Code (CIC) Section 1215.5(b)(4). It is recommended that the Company submit any future amendments to the CDI for approval.

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#### TERRITORY AND PLAN OF OPERATION

As of December 31, 2009, the Company was licensed to transact business in the following fourteen States:



Arizona	Kansas	Oklahoma	Washington
California	Maine	Oregon	Wyoming
Colorado	Montana	Texas	
Idaho	Nevada	Utah	

The Company offered a range of personal and commercial insurance products including automobile, homeowners, commercial multi-peril, fire, casualty, and other property and casualty insurance to individuals and businesses. By the end of 2008, the Company was only actively writing in the State of Oklahoma. The principal line of business written is personal nonstandard automobile liability and physical damage coverage. The Company's products are marketed by 194 independent agents. In 2009, direct premiums written were \$10.8 million.

### REINSURANCE

#### Assumed

The Company has no assumed business.

#### Ceded

On June 17, 1999, the Company entered into an Amended and Restated Quota Share Reinsurance Agreement (QSRA) with its parent, Trinity Universal Insurance Company (Trinity). Under the terms of this agreement, the Company cedes 90% of its direct and assumed business net liability (net of all other reinsurance) on all inforce policies written or assumed by the Company at the date of the agreement and on all of its policies written or renewed after the effective date of the agreement. The California Department of Insurance (CDI) approved this agreement on February 23, 2005.

Effective July 1, 2009, the Company and Trinity entered into a Second Amended and Restated 100% Quota Share Reinsurance Agreement (100% QSRA), which replaced the Amended and Restated 90% QSRA. The CDI issued a non-objection notice to the execution of this agreement on October

27, 2009. Under the terms of this reinsurance agreement, the Company cedes 100% ultimate net loss with respect to its existing and new business to Trinity. The Second Amended and Restated 100% QSRA also provides for administration of the business by Trinity unless Trinity assigns all or part of its administrative responsibilities to one or more of its affiliates. On December 10, 2010, the CDI approved a Third Amended and Restated 100% Quota Share Reinsurance Agreement. The Company reported total reinsurance recoverables of \$1.4 million or 7% of the reported surplus as of the examination date.

### ACCOUNTS AND RECORDS

#### Deferred Tax Assets

The Company has not elected to admit deferred tax assets in the amount of \$13,867,346 pursuant to Statements of Statutory Accounting Principles Number 10R, paragraph 10.e. Such election was not available for 2008. This amount is reflected as a cumulative effect of changes in accounting principles.

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2009

Underwriting and Investment Exhibit for the Year Ended December 31, 2009

Reconciliation of Surplus as Regards Policyholders from December 31, 2006  
through December 31, 2009

Statement of Financial Condition  
as of December 31, 2009

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 13,724,661	\$	\$ 13,724,661	(1)
Real Estate:				
Properties held for the production of income	7,273,341		7,273,341	
Cash and short-term investments	647,423		647,423	
Investment income due and accrued	237,403		237,403	
Premiums and agents' balances in course of collection	2,185,539	270	2,185,269	
Amounts recoverable from reinsurers	1,399,085		1,399,085	
Net deferred tax asset	433,487	433,487	0	
Guaranty funds receivable or on deposit	1,403		1,403	
Aggregate write-ins for other than invested assets	<u>76,772</u>	<u>63,426</u>	<u>13,346</u>	
Total assets	<u>\$ 25,979,114</u>	<u>\$ 497,183</u>	<u>\$ 25,481,931</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 0	(2)
Loss adjustment expenses			0	(2)
Commissions payable, contingent commissions and other similar charges			105,553	
Other expenses			28,179	
Taxes, licenses and fees			182,946	
Advance premiums			15,514	
Ceded reinsurance premiums payable			2,185,639	
Funds held by company under reinsurance treaties			789,265	
Amounts withheld or retained by company for account of others			2,330	
Provision for reinsurance			279,818	
Payable to parent, subsidiaries and affiliates			2,679,069	
Aggregate write-ins for liabilities			<u>15,482</u>	
Total liabilities			6,283,795	
Common capital stock	\$ 2,600,000			
Gross paid-in and contributed surplus	12,814,580			
Unassigned funds (surplus)	<u>3,783,556</u>			
Surplus as regards policyholders			<u>19,198,136</u>	
Total liabilities, surplus and other funds			<u>\$ 25,481,931</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2009

Statement of Income

Underwriting Income

Premiums earned		\$ 555,930
Deductions:		
Losses incurred	\$ 128,989	
Loss adjustment expenses incurred	22,045	
Other underwriting expenses incurred	<u>149,381</u>	
Total underwriting deductions		<u>300,415</u>
Net underwriting gain		255,515

Investment Income

Net investment income earned	\$ 677,789	
Net realized capital gain	<u>28,794</u>	
Net investment gain		706,583

Other Income

Net loss from agents' or premium balances charged off	\$ (17,123)	
Finance and service charges not included in premiums	<u>35,015</u>	
Total other income		<u>17,892</u>
Net income		<u>\$ 979,990</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2008		\$ 21,056,534
Net income	\$ 979,990	
Change in net deferred income tax	2,098,951	
Change in nonadmitted assets	11,866,049	
Change in provision for reinsurance	(266,777)	
Cumulative effect of changes in accounting principles	(13,867,436)	
Aggregate write-ins for losses in surplus	<u>(2,669,175)</u>	
Change in surplus as regards policyholders		<u>(1,858,398)</u>
Surplus as regards policyholders, December 31, 2009		<u>\$ 19,198,136</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2006 through December 31, 2009

Surplus as regards policyholders, December 31, 2006,  
per Examination

\$ 17,396,325

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>
Net income	\$ 4,525,293	\$
Change in net deferred income tax	2,468,458	
Change in nonadmitted assets	11,379,617	
Change in provision for reinsurance		34,946
Cumulative effect of changes in accounting principles		13,867,436
Aggregate write-ins for losses in surplus		<u>2,669,175</u>
Totals	<u>\$ 18,373,368</u>	<u>\$ 16,571,557</u>

Net increase in surplus as regards policyholders

1,801,811

Surplus as regards policyholders, December 31, 2009,  
per Examination

\$ 19,198,136

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Bonds

The Illinois Insurance Department, the lead state for this multi-state coordinated examination, performed a review of the Unitrin Group's custodial agreements. They noted that a number of the custodial agreements did not contain all of the required provisions in accordance with the National Association of Insurance Commissioners Financial Condition Examiners Handbook. The examination finding pertained to various entities within the Group, including the California Companies. It is recommended that the Company draft a new custodial agreement to remedy the deficiencies and submit it to the California Department of Insurance (CDI) in accordance with the California Insurance Code Section 1104.9.

### (2) Losses and Loss Adjustment Expenses

Based on the analysis by a Casualty Actuary from the California Department of Insurance, the Company's December 31, 2009 reserves for losses and loss adjustment expenses were determined to be reasonably stated. The Company reported no net loss and loss adjustment expense reserves due to the 100% cession.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Management and Control – Management Agreements – Federal Income Tax Agreement (Page 6): Amendments to the Federal Income Tax Agreement were made after January 1, 1997 and were subject to the prior approval requirements of the California Insurance Code (CIC) Section 1215.5(b)(4). It is recommended that the Company submit any future amendments to the California Department of Insurance (CDI) for approval.

Comments on Financial Statement Items – Bonds (Page 12): It is recommended that the Company draft a new custodial agreement to remedy the deficiencies and submit it to CDI in accordance with CIC Section 1104.9.

#### Previous Report of Examination

Management and Control – Management Agreements – Administrative Services Agreement (Page 4): It was recommended that the Company comply with the terms and provisions of the Administrative Service agreement with Trinity and its affiliates for providing certain services by the Company's personnel based in Oregon. This agreement was terminated.

Accounts and Records – Commingling of Assets (Page 10): It was recommended that the Company comply with CIC Sections 1100 and 1104.1. The Company has complied by entering into a restated 100% Quota Share Reinsurance Agreement, Security Trust Agreements and Administrative Services Agreement. All agreements were subsequently approved by the CDI.

Accounts and Records – Related Party Settlements (Page 11): It was recommended that the Company maintain adequate documentation to support financial statement accounts. The Company has implemented a new general ledger system in 2009 and believes the related party settlements are easier to follow and understand.

## ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

\_\_\_\_\_/s/\_\_\_\_\_  
Victoria Wang, CFE  
Examiner-In-Charge  
Department of Insurance  
State of California